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No. 87-600

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In the Supreme Court of the United States

OCTOBER TERM, 1987

THE VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, INDIVIDUALLY, AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY BRIEF FOR THE PETITIONERS

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TABLE OF AUTHORITIES

Cases: Page

Grainger v. *State Sec. Life Ins. Co.*, 547 F.2d 303 (5th Cir.), rehearing en banc granted, 553 F.2d 1008, rehearing en banc vacated and opinion on rehearing, 563 F.2d 215 (1977), cert. denied, 436 U.S. 932 (1978) 5

Group Life & Health Ins. Co. v. *Royal Drug Co.*, 440 U.S. 205 (1979) 6

International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551 (1979) 5

Marine Bank. v. *Weaver*, 455 U.S. 551 (1982) 5

Olpin v. *Ideal National Ins. Co.*, 419 F.2d 1250 (10th Cir. 1969), cert. denied, 397 U.S. 1074 (1970) 5

Peoria Union Stock Yards Co. v. *Penn Mut. Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983) 5

SEC v. *National Securities, Inc.*, 393 U.S. 453 (1969) 6

SEC v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) 3, 9

SEC v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) 3, 8, 9

Statutes, regulations and rules:

Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq.* 8

McCarran-Ferguson Act, 15 U.S.C. §§ 1011 *et seq.* 6

Securities Act of 1933, Section 3(a)(8), 15 U.S.C. § 77c(a)(8) 2, 3

SEC Rule 151, 17 C.F.R. § 230.151, 51 Fed. Reg. 20,254 (1986) ..... *passim*

Miscellaneous:

PLI, *Insurance Products under the Securities Laws* (Corporate Law and Practice Handbook No. 493, B4-6726, 1985) 7

SEC Release 6051, 44 Fed. Reg. 21,626 (1979) 10

SEC Release 6558, 49 Fed. Reg. 46,750 (1984) 3, 8

REPLY BRIEF FOR THE PETITIONERS

In our petition, we showed that the court of appeals' decision—which is the first ever holding a fixed annuity product to be subject to the federal securities laws—is both erroneous and of substantial public importance. The significance of the decision below is clearly demonstrated by the five *amicus curiae* briefs that the insurance industry, state insurance commissioners, and state guaranty associations have filed in this Court urging that review be granted. These expressions of concern attest to the unprecedented nature of the court of appeals' ruling and the serious disruption it portends for the insurance business and the system of state insurance regulation.

Respondent's brief in opposition offers no credible reason why this Court's review is not warranted. Respondent largely abandons the court of appeals' reasoning and advances no tenable standard of her own for distinguishing "insurance" from "securities." Rather, she devotes the bulk of her brief to alternative grounds for the decision below that by her own admission the court of appeals did not adopt and that in fact it rejected. Moreover, apart from her repeated *ipse dixit*, respondent utterly fails to refute the showing in the petition and the *amicus* briefs of the public importance of this case.

I.

Nowhere in her brief in opposition does respondent defend the rationale of the court of appeals' decision or answer our argument that the decision rests on a serious misconception of SEC Rule 151. Respondent merely reiterates the Seventh Circuit's misunderstanding of the Rule (Br. in Opp. 11, 12):

> [T]he SEC has determined that unless a contract guarantees the excess rate of interest for a minimum of one year the purchaser/investor has the investment risk.

* * * * *

> Section (b)(3) of Rule 151 is an objective test, as determined by the SEC, as to when the investment risk shifts from the participant to the insurer, that being when the insurer guarantees that the excess interest rate will remain in effect for at least one year.

Rule 151 provides no such test. Rather, as the SEC explained in promulgating the Rule, it establishes a standard for determining those annuities that are "*clearly*" excluded from the federal securities laws and thus are given the Commission's "*assurance* that [they are] covered by the section 3(a)(8) exclusion." 51 Fed. Reg. 20,254, 20,255 (1986) (emphasis added). Contrary to respondent's characterization, Rule 151 creates a safe harbor, not a comprehensive definition of exempt annuities, and the failure to meet the stringent test for safe-harbor treatment in no way suggests that an annuity therefore becomes a security. See Pet. 20-22.[1]

Compounding her misinterpretation of Rule 151, respondent also misconstrues the applicable legal standard under this Court's decisions for determining whether an annuity product is subject to the securities laws. In her view, an annuity, to be excluded, must "impose[] no investment risk" on the purchaser (Br. in Opp. 6).

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[1] Respondent charges (Br. in Opp. 1, 7) that VALIC misrepresented its policy to the courts below. While it is not material to the question presented in this Court, we must note that respondent's accusation is entirely without merit, as outlined in the petition (at 7-8 n.3) and more fully explained in VALIC's submissions to the court of appeals. See, *e.g.*, VALIC's C.A. Br. 18 ("[a]lthough VALIC is not required by the contract to refrain from modifying excess interest for one year, in practice VALIC preserved (or improved) the interest bands during the entire class period"); Tr. of Oral Arg. 15 (statement of VALIC's counsel) ("[t]he product at issue in this case at the time it was involved in the class case did not comply with that one requirement under proposed rule 151"); *id.* at 7 (Judge Cudahy: "They * * * do not qualify under the proposed rule that interest can only be recalculated every year and they have recalculated every 3 months, as I understand it." Counsel for respondent: "That is right").

As the Court stated in *VALIC I*, however, a policy is an excluded annuity and not a covered security if it provides "*some guarantee* of fixed income" and "involves *some investment risk-taking* on the part of the company. * * * '[I]nsurance' involves a guarantee that *at least some fraction* of the benefits will be payable in fixed amounts" (359 U.S. at 71) (emphasis added). In fact, the SEC has specifically recognized that *VALIC I* and *United Benefit* "do not require the insurer to assume *all* investment risk for a contract to be insurance under section 3(a)(8)." 49 Fed. Reg. 46,750, 46,752 (1984) (emphasis in original). And even the safe harbor of Rule 151 does not require that the insured bear *no* investment risk.[2]

Under *VALIC I* and *United Benefit*, VALIC's excess interest fixed annuity was not a security, as the court of appeals correctly concluded in its initial decision. VALIC guaranteed payment of both principal (including accrued interest) and a specified rate of interest. Thus, its policy had the essential features of a traditional fixed annuity, and VALIC assumed a substantial—indeed, the predominant—investment risk under the policy. As illustrated by the recent stock market drop, these guarantees afford substantial protections for policyholders who wish, as with all insurance products, to have the peace of mind that their retirement funds are secure and are being managed in a conservative manner.[3]

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[2] Respondent relies (Br. in Opp. 15) on the fact that the SEC, although not a party (compare *VALIC I* and *United Benefit*), has not sought to file a brief as *amicus curiae* in this Court. Of course, it is the customary practice of the federal government not to participate as an *amicus* at the petition stage. However, in light of respondent's emphasis on the absence of the SEC, her substantial misinterpretation of SEC Rule 151, and the obvious importance of this case to the SEC, the Court may wish to invite the Solicitor General to submit a brief expressing the views of the United States.

[3] Because VALIC guaranteed full payment of all credited principal and interest (including accrued excess interest) and also

Respondent contends, however, that VALIC's guaranteed rate of 4% interest (3½% after the first 10 years) on past and future deposits—which was comparable to that guaranteed by other insurers on similar fixed annuities at the time—was below the rate of return on various investments and was too low to constitute a meaningful investment risk (Br. in Opp. 5-6, 9, 14, 18). The court of appeals expressly found to the contrary, concluding that the guaranteed rate was sufficient to place a substantial investment risk on VALIC (Pet. App. 8a-9a). Moreover, even for purposes of the safe harbor, the guaranteed rate of interest need only be equal to that set in the nonforfeiture provision of the insurance law (see Rule 151(b)(2)(ii) and (c)), which during the relevant period was 3% (see Pet. App. 12a & n.3). And more fundamentally, as explained in the petition (at 18 n.8), it is an integral feature of this long-term insurance product that the guaranteed rate of interest be below prevailing shorter-term market rates of return (which do not include protection of principal and minimum interest payments on future deposits) in order to ensure that the guarantee can be safely and reliably maintained over the life of the annuity. That the excess interest provision may have been a significant part of the economic inducement for customers to purchase this policy, as respondent emphasizes, does not negate the fact that the fundamental characteristic of VALIC's fixed annuity was the guarantee of principal and interest and that this guarantee placed a substantial investment risk on VALIC.

The cases cited by respondent (Br. in Opp. 8-10) do not support the court of appeals' decision. Indeed, the court itself did not rely on those cases; on the contrary, despite respondent's citation to them below, the court

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guaranteed to pay 3½-4% interest on all future deposits, respondent is incorrect in asserting (Br. in Opp. 13) that "if any investment risk to VALIC looked likely to occur all VALIC needed to do to eliminate its risk was lower the interest it paid on past 'bands.'"

in its original decision held that VALIC's fixed annuity was *not* a security.[4]

Respondent also fails to distinguish the decisions of this Court, such as *Marine Bank* and *Daniel*, that have looked to the existence of alternative regulatory systems in determining whether a particular instrument is a security (see Pet. 15, 23-24, 28). Respondent is simply wrong in contending that "no fraud protection exists [here] except the Securities Acts" (Br. in Opp. 20); state insurance codes, as well as state fraud law generally, prohibit false and deceptive practices by insurance companies (see Pet. 25; see also Nat. Ass'n of Ins. Comm'rs Am. Br. 7). Moreover, the fact that this protection is afforded under state law is not a controlling distinction, as respondent suggests (Br. in Opp. 20-21),

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[4] In *Peoria Union Stock Yards Co.* v. *Penn Mut. Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983), the "group deposit administration annuity contract" contained, in contrast to VALIC's fixed annuity, no guarantee of interest after the first three years (*id.* at 322, 325); instead, it provided that all net interest earned was required to be credited to the account (*id.* at 322, 325), so that "the income available to fund th[e] obligations fluctuated with the investment experience of Penn Mutual. * * * It was as if the pension trustees had bought shares in a mutual fund" (*id.* at 325). In *Grainger* v. *State Sec. Life Ins. Co.*, 547 F.2d 303 (5th Cir.), rehearing en banc granted, 553 F.2d 1008, rehearing en banc vacated and opinion on rehearing, 563 F.2d 215 (1977), cert. denied, 436 U.S. 932 (1978), the court of appeals held that a "variable investment plan"—which, again in contrast to VALIC's fixed annuity, contained no guaranteed rate of interest and required that 90% of the profits earned be allocated to the benefit of policyholders (547 F.2d at 304-305)—was not an annuity as a matter of law and could be a security only if it was promoted as an investment rather than insurance and if the policyholders' payments were disproportionately high in relation to the death benefits offered (*id.* at 306-307, 563 F.2d at 216).

Instead of *Peoria Union* and *Grainger*, the closest analogy to the present case is *Olpin*, a decision that is plainly at odds with the approach of the court below (see Pet. 20). The fact that *Olpin* involved a whole life insurance policy issued by a mutual insurance company is a formal difference that does not, as respondent asserts (Br. in Opp. 8), distinguish the essential features of that case from this one.

because Congress determined in the McCarran-Ferguson Act that there should be state rather than federal regulation of the business of insurance.

Respondent's interpretation of the McCarran-Ferguson Act is also unfounded. That Act, together with the explicit exemption in the securities laws for insurance and annuities, strongly counsels against extending the federal securities statutes to fixed annuities, an insurance product traditionally regulated by the states. In *SEC* v. *National Securities, Inc.*, 393 U.S. 453 (1969), upon which respondent relies (Br. in Opp. 19), the Court simply held that an insurance company's acquisition of the stock of another insurer in connection with a merger does not involve the "business of insurance" within the meaning of the McCarran-Ferguson Act. See 393 U.S. at 457-461; see also *Group Life & Health Ins. Co.* v. *Royal Drug Co.*, 440 U.S. 205, 230-231 n.38 (1979). That holding has no application here, since the issuance of excess interest fixed annuities clearly constitutes the business of insurance and has traditionally been subject to exclusive state regulation.

The *amicus* brief of the National Association of Insurance Commissioners, which is submitted on behalf of the insurance regulatory officials of all 50 states and the District of Columbia, is a compelling indication of the conflict between the decision below and the McCarran-Ferguson Act policy of exclusive state insurance regulation. As that brief demonstrates (at 4, 7), "[t]he court of appeals' opinion impacts the traditional state regulatory approach to the sale of fixed annuities," under which excess interest fixed annuities have been "exclusively governed by the state insurance laws and regulations." Respondent's position simply reads the Act out of the case.

II.

Unable to defend the reasoning of the court of appeals, respondent argues that its decision is not of sufficient importance to warrant further review. She asserts

(Br. in Opp. 1, 15) that the decision below pertains only to VALIC's excess interest fixed annuity and will not affect other policies or companies. That contention is belied by the numerous *amicus* submissions, which demonstrate the widespread consequences of the decision below.[5] As these briefs show, many companies have issued a large number of excess interest fixed annuities like VALIC's, as well as other insurance products that operate analogously to excess interest policies (such as participating life insurance contracts). Thus, "[t]he precedent established in the court of appeals' decision could place an extensive portion of the annuities currently subject to state regulatory oversight under the control of federal securities laws" (Nat. Ass'n of Ins. Comm'rs Am. Br. 7).

Respondent also states (Br. in Opp. 16) that five companies had registered their fixed annuities with the SEC as securities prior to the court of appeals' decision. Even if those contracts were fixed annuities comparable to VALIC's, the fact that five companies, out of hundreds or thousands in the field, chose to file registration statements for a relatively small number of policies is hardly meaningful. In fact, however, all of these registered policies (including that of the Hartford Life Insurance Company) did not resemble VALIC's fixed annuity because they contained a so-called market value adjustment feature that could result in the invasion of the policyholder's principal. See 51 Fed. Reg. at 20,257 n.19; PLI, *Insurance Products under the Securities Laws* 15, 73, 77-78 (Corporate Law and Practice Handbook No. 493, B4-6726, 1985). This adjustment feature is a means of shifting a significant investment risk from the insurer to the insured by reducing the amount payable upon withdrawal. Such a contract, unlike an excess interest fixed annuity, is entirely ineligible for the safe harbor

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[5] See Amer. Coun. of Life Ins. Am. Br. 2; Nat. Ass'n of Life Cos. Am. Mot. ii & Br. 3; Nat. Ass'n of Ins. Comm'rs Am. Br. 7; Ass'n of Calif. Life Ins. Cos. Am. Mot. iii & Br. 4.

of Rule 151 (51 Fed. Reg. at 20,256-20,257 & nn. 14-19; 49 Fed. Reg. at 46,752 & n.17).[6]

Finally, noting that the employees of VALIC's subsidiary (VAMCO) who sell its annuity policies are already registered as NASD representatives, respondent argues (Br. in Opp. 2, 17, 24) that it would not be a significant burden for insurance agents to register under federal "broker-dealer" requirements as a result of the court of appeals' decision. VALIC's agents are so registered (as well as also being registered as insurance agents pursuant to state law) because a portion of their business consists of variable annuities that *VALIC I* held to be securities. But as the *amicus* briefs indicate, registration of insurance agents as NASD representatives is not the common practice in the insurance industry. Contrary to respondent's contention, this registration requirement—as well as the numerous other requirements of federal law that would become applicable (see Pet. 9, 12-14, 27-28)—shows the disruptive effect of the court of appeals' decision.

III.

Having failed either to justify the Seventh Circuit's analysis or to minimize the significance of its decision, respondent seeks to avoid further review by advancing a miscellany of alternative grounds for affirmance of the judgment.[7] These arguments, even if meritorious, would not provide a reasonable basis for leaving in place a de-

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[6] Respondent further relies (Br. in Opp. 16-17) on a statement of an insurance association lawyer at an ALI-ABA conference that registration of these annuities had not been "terribly burdensome" and would not pose a problem under the Investment Company Act for "[m]ost companies." However, given the small number of companies and contracts involved, those observations do not shed any light on the consequences of holding standard excess interest fixed annuities to be securities.

[7] Respondent concedes that her arguments, although presented below, were not adopted by the court of appeals. In fact, the court rejected these arguments in its first opinion, which held that VALIC's fixed annuity was not a security. Nothing in the court's subsequent reconsideration revived these previously rejected claims.

cision that is both erroneous and of substantial public importance. But the arguments are in fact unavailing.

Respondent first argues (Br. in Opp. 4, 6, 18, 21-22, 24) that VALIC's fixed annuity constituted an option on a security because it was part of a combination contract that permitted the purchase of a variable annuity (which, under *VALIC I*, was a security). However, the combination contract did not involve an option at all. It was simply a procedure for transferring funds between the fixed and variable plans at the current market price, not a right to purchase a variable annuity at a predetermined preferential price; it therefore did not represent a significant right under the contract, since the general public equally could buy a variable annuity at the market price. Beyond that, even if the combination contract could be said to contain an option, that does not mean that the option was included in the fixed annuity, which is what is at issue in this case. See Pet. App. 3a (plaintiff class certified as all Illinois participants "in VALIC's fixed annuity plan" between 1975-1982).

Respondent also asserts (Br. in Opp. 3, 17, 23) that the fixed annuity should be divided into an "accumulation phase" and a "pay-out phase" and that this case involves only the accumulation phase. However, unlike the unusual circumstances presented in *United Benefit* (387 U.S. at 207-210), there is no basis here for separating an integrated policy into two divisible parts. When a fixed annuity policyholder entered into the contract with VALIC and began to make payments (the so-called accumulation phase), he was guaranteed minimum annuity purchase rates based on mortality assumptions then in effect, which assured him the right to purchase an annuity at any time thereafter at those rates (the so-called pay-out phase); in contrast, if the policyholder withdrew his money upon retirement and purchased an annuity from another company, it would be based upon the then-current annuity rates, which could be less favorable than the minimum rates in VALIC's contract. Moreover, again unlike *United Benefit*, during the accumulation

phase VALIC guaranteed principal and specified interest, and it included the premiums in its general account and invested them in long-term debt-type instruments pursuant to state insurance law.

Respondent next contends (Br. in Opp. 12, 24) that VALIC's fixed annuity was a security because it did not meet any of the elements of SEC Rule 151. However, notwithstanding respondent's claim (*id.* at 5 & n.1, 24) that the policy was marketed as an investment and not as an insurance product, both the court of appeals and the district court concluded that VALIC promoted its fixed annuity plan as insurance (Pet. App. 8a-9a, 13a, 40a-41a); respondent has presented no reason for this Court to reconsider, let alone to overturn, the concurrent determination of the courts below. Furthermore, contrary to respondent's unsupported and highly implausible assertions (Br. in Opp. 2, 25), VALIC's fixed annuity business, including its sales agents, was in fact regulated by the Illinois insurance commissioner. Thus, apart from the "one-year excess interest" guarantee that was the basis for the court of appeals' decision on rehearing, "VALIC's fixed annuity satisfies all of the requirements of Rule 151" (Pet. App. 12a).

Finally, respondent asserts (Br. in Opp. 13-15) that VALIC's fixed annuity did not meet the standards of SEC Release 6051, which was in effect prior to the adoption of Rule 151, because the policy involved no mortality risk for VALIC. As explained above, however, VALIC's fixed annuity guaranteed that the annuity purchase rates in existence when the contract was initiated would be available upon annuitization at any time in the future; because the purchase rates were based on then-current life expectancies, this guarantee imposed on VALIC the mortality risk that the policyholder would in fact live longer than his predicted life span as of the point the rates were computed. The SEC has recognized that guaranteed annuity purchase rates entail a mortality risk. See SEC Release 6051, 44 Fed. Reg. 21,626, 21,627-21-628 (1979).

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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